Invesco

Investment Insights | Invesco Global Liquidity

Global Liquidity Snapshot

An at-a-glance look at what's happening in short-term liquidity markets around the world

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1Q highlights

US

The Federal Open Market Committee (FOMC) kept short-term interest rates unchanged in March at 5.25%-5.50%, indicating that progress on inflation implies no further rate hikes for 2024. The FOMC median "dot", or policy rate forecast, was revised to reflect a 75-basis point easing of interest rates in 2024. The Federal Reserve (Fed) has remained data-dependent and has provided conditional guidance that rates will remain higher for longer, advising that monetary policy is in restrictive territory and that it remains committed to bringing inflation down to its 2% target. The US labor market has moderated but remains resilient. Inflation has been on a slow downward trajectory but remains above the FOMC's comfort level. During the quarter, money market fund industry assets hit a record high of $6.108 trillion. Short-term interest rates remain near the highest they have been in nearly 20 years, and money market funds continue to be a leading cash management investment vehicle for investors. (1)

UK

The Bank of England (BoE) left its official bank rate unchanged on the 20th March 2024, as expected. The Monetary Policy Committee (MPC) voted by a majority of 8–1 to maintain the Bank Rate at 5.25%, a 16-year high. Two of the most hawkish members, Mann and Haskel, dropped their dissents favoring a hike. The main policy language was unchanged, with the minutes reiterating that the Committee will "keep under review for how long the Bank Rate should be maintained at its current level". The MPC members who voted for a hold noted that further evidence would be required before changing the monetary policy stance. Wage growth in the United Kingdom (UK) slowed from record highs, with average earnings, excluding bonuses, 3.5% higher in the three months to January than in the previous quarter. Headline CPI for February came in lower than expected at 3.4%. Core Inflation slowed to 4.5% in February from 5.1% in January, slightly below both market and BoE forecasts. (2)

Europe

One- to three-year corporate credit spreads had a strong quarter in Q1, falling from 116 basis points to 90 basis points, bringing them to their tightest level since Q1 2022. Several factors have driven this narrowing, including strong inflows into credit funds, new issuance which was easily absorbed, falling inflation and expectations that the European Central Bank (ECB) could start cutting interest rates by June.

Recent eurozone economic data have also been encouraging. Forward-looking composite PMI's rose to 49.9 from 49.2, though while still in contractionary territory (i.e below 50), they were off their lows and on an upward trajectory. Labour market data have remained robust, with job openings elevated. Nevertheless, wages are coming off their highs, though not in a straight line. Sentiment indicators, such as industrial confidence, also appear to be improving. The exception is Germany, which continues to underperform. But even there, the business climate has improved, though the index remains well below its long-term average. (3)

1. Sources: Bloomberg LP, Federal Reserve as of 3/20/24; Investment Company Institute (ICI) as of 3/27/24
2. Source: Bloomberg LP, Bank of England as of 3/21/24, UK Office for National Statistics as of 3/12/24, 3/20/24
3. Source: Bloomberg LP, ICE Bond Indices as of 3/31/24, S&P Global as of 3/21/24.

> *We are monitoring US economic data for any weakness or strength that could push the FOMC to deviate from current market expectations for policy rates.*

Key areas to watch

US

- We are closely monitoring US economic data releases, examining them for any weakness or strength that could push the FOMC to deviate from the market's current pricing of short-term interest rates.
- Additionally, we are watching for any tightening of credit conditions, given reduced bank lending and the challenges facing the commercial real estate market.

UK

- **Inflation:** Inflation remains above the BoE's target with core services slightly stronger than expected. The strength might be partly due to a new methodology employed by the Office for National Statistics. The MPC has maintained that the stickiness of services inflation is a major concern.
- **Labour:** The labour market puzzle is getting a little clearer now that we have more confidence in the new measures initiated following a temporary model used for a few months. Unemployment is still very low, but from an overall growth perspective, many workers are still not looking for jobs, which could impact prospects.
- **MPC member comments:** BoE commentary has leaned slightly dovish, with the Committee stating that the labour market continued to loosen – despite recently released Labour Force Survey data showing the unemployment rate declining through the second half of last year – and arguing that policy could remain restrictive even after a cut.

Europe

- **Labour markets:** The labour market is strong and the unemployment rate remains close to historic lows, so we are watching wage growth carefully. However, total hours worked has remained subdued and are still below pre-pandemic levels.
- **Inflation:** Headline inflation has continued to decline and stood at 2.6% year-over-year as of February. But recent core inflation data have surprised to the upside. Seasonal factors in March and April tend to generate short-term volatility, so we will be focused on the longer-term average to avoid misleading signals. [(4)]
- **Manufacturing data:** The composite eurozone PMI excluding France and Germany rose to 53.6 from 52.5 compared to 47.9 for the eurozone overall. Improvements in Germany and France could brighten the picture for the eurozone. [(5)]

Investment implications

US

- We are closely monitoring flows within the money market fund industry in conjunction with potential changes in the Fed's forward guidance.
- Inflation should continue to moderate in 2024, although it will likely remain higher than the Fed's target.
- We expect continued interest rate volatility as the market prices a terminal federal funds rate amid resilience in the US economy.

UK

- **Cuts to begin:** Recent data have increased the probability that the BoE will start cutting rates this summer, potentially as soon as the June meeting. The markets currently expect three quarter-point reductions between May and December, taking rates from 5.25% to 4.50%. The markets imply a ~70% chance of a 25-basis point June rate cut. [(6)]
- **Continuing to extend:** Sterling money market weighted average maturities have been extended over the last few months. We expect this trend to continue, as we believe rates have peaked.

4. Sources: Bloomberg LP, Eurostat as of 3/18/24

5. Sources: Bloomberg LP, S&P Global, as of 3/21/24

6. Sources: Bloomberg LP, as of 3/29/24

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The market has priced in the likelihood of a cut in the federal funds rate in 2Q but stronger data may cause the market and Fed to reassess the potential rate paths.

Investment implications

Europe

- **ECB rate cuts:** Although headline inflation is close to the ECB’s target, we think the risks going forward are symmetric, with negative surprises as likely as inflation stickiness. But we still believe the ECB will cut rates in Q2.
- **Inverted curve:** Due to expectations of ECB rate cuts in Q2, the yield curve is now inverted from six to twelve months. Yields on A-1+ fixed rate paper, currently around 3.75% to 3.50%, are considerably lower than overnight deposit yields of closer to 3.90%. (7)

Outlook

US

Base case

- We believe the end of the rate hiking cycle does not mean that the easing cycle will begin immediately. The Fed will likely remain on hold to ensure that the data are consistently moving toward its inflation target. Money market funds will likely benefit from this higher-for-longer short-term interest rate scenario.

Risks:

- The market has priced in the likelihood of a decline in the federal funds rate beginning in 2Q but stronger data may cause the market to reassess the Fed’s potential rate path.
- Duration extension may impact flows at the front-end of the US yield curve.

UK

Base case

- **Policy has peaked:** The recent moderation in UK inflation and wage data has driven a compression of interest rate differentials versus both the US and eurozone, potentially raising a headwind for future GBP appreciation. However, for the time being, buoyant global risk appetite, better sentiment toward the UK and European growth outlooks and some signs of equity-related inflows might provide the GBP with some support.
- **Inflation progress:** We expect further progress towards the BOE’s inflation target, with a potential sharp fall in energy prices likely to push headline inflation close to target by the middle of the year. Short-term momentum also points to a likely decline in core inflation on a year-over-year basis. The start of the BoE cutting cycle should eventually provide downside pressure to front-end yields.

Risks

- **Wage growth:** The UK minimum wage will likely keep the BoE on high alert for signs that pay growth is feeding inflation, even as broader price pressures in the economy start to ebb.
- **Deficit:** Valuations on a nominal and real trade-weighted basis are relatively rich and fundamentally the UK remains a current account deficit economy with slow growth, a vulnerability to global shocks and questionable fiscal and monetary credibility.
- **The MPC committee remains divided:** The minutes made a point of highlighting this division. Hawkish member of the committee might not be ready to vote for cuts in June.

Europe

Base case

- **Improvement:** We believe the eurozone will avoid a recession, as global PMI’s have been improving. This should help export markets, and sentiment is improving in Germany, the current laggard within Europe. The latest IFO German Manufacturing Business Expectations survey showed sharp improvement.

Risks

- **Sticky inflation:** Driven by a strong labour market, wages could remain too high or productivity may not improve sufficiently to be consistent with the ECB’s inflation target, preventing it from cutting rates in Q2, or further forestalling potential rate cuts.

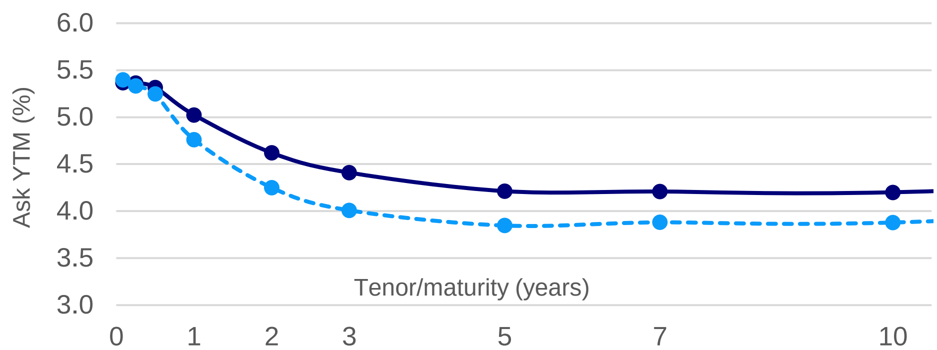
7. Sources: Bloomberg LP, as of 3/31/24

Data spotlight

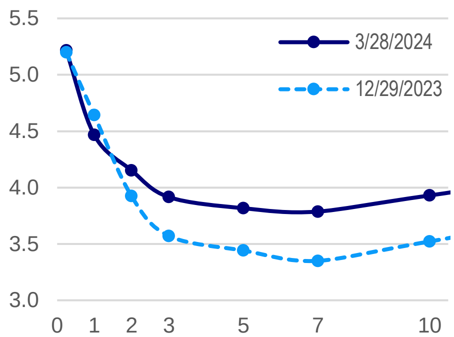
Curve inversion nearing two years

Going on 21 months, curve inversions among longest in history. Debate is which end gives in first. Do short rates eventually rally on central bank accommodation or do long rates continue upward trek on strength and high for longer narrative?

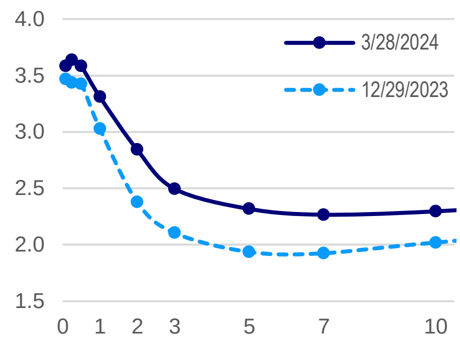
US Treasury yield curve [8]



UK Government curve [8]



German Government curve [8]



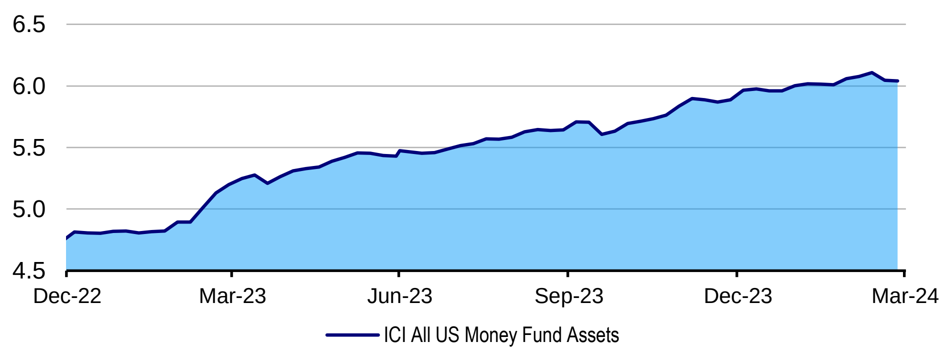
Evolving US money market landscape

US money funds continued to hit record highs in 1Q.

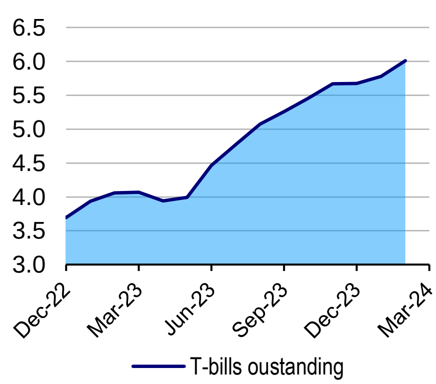
US Treasury Bill supply higher while reliance on Fed's Overnight Reverse Repurchase Program has declined.

We are watching the Fed's QT and potential changes their Policy Normalization framework to keep banking reserves at sufficient levels.

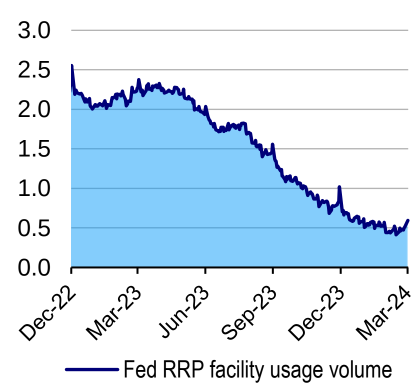
US Money Market Fund Assets ($ trillion) [9]



US Treasury Bills Outstanding [10]



Fed ON RRP Usage [11]



8. Sources: Bloomberg LP as of 3/28/24
9. Sources: Bloomberg LP, Investment Company Institute (ICI) as of 3/27/24
10. Sources: Bloomberg LP, US Treasury as of 2/29/24
11. Sources: Bloomberg LP, Federal Reserve as of 3/31/24

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Invesco Global Liquidity

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